



Yale ICF Working Paper No. 02-33

June 14, 2004

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First draft June 29, 2002
Current draft: June 14, 2004

Abstract: Funds of funds are an increasingly popular avenue for hedge fund investment. Despite the increasing interest in hedge funds as an alternative asset class, the high degree of fund specific risk and the lack of transparency may give fiduciaries pause. In addition, many of the most attractive hedge funds are closed to new investment. Funds of funds resolve these issues by providing investors with diversification across manager styles and professional oversight of fund operations that can provide the necessary degree of due diligence. In addition, many such funds hold shares in hedge funds otherwise closed to new investment allowing smaller investors access to the most sought-after managers. However, the diversification, oversight and access comes at the cost of a multiplication of the fees paid by the investor. One would expect that the information advantage of funds of funds would more than compensate investors for these fees. Unfortunately, individual hedge funds dominate fund of funds on an after-fee return or Sharpe ratio basis. In this paper we argue that the disappointing after-fee performance of some fund of funds might be explained by the nature of this fee arrangement, and that fund of funds providers may actually benefit from considering other possible fee arrangements. These alternative arrangements will improve reported performance and may make funds of funds more attractive to a growing institutional clientele.

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Acknowledgments: We should like to acknowledge the extremely helpful and constructive comments of John Bilson, Edwin Elton, Ravi Dattatreya, Erol Emed, Martin Gruber, Bruce Grundy, Richard Green, Adriaan Klop, Richard McAloney, Frank Milne, Tom Schneeweis, Peter Swan and Laurens Swinkels, without of course implicating them in any errors of omission or commission that remain. We would also like to thank participants at the 2002 SIRCA Funds Management conference, Sydney and 2003 EFA Meetings in Glasgow, and presentations at Boston College, Melbourne University, New York Fed, Queens University and Wharton Financial Institutions Center for helpful comments.

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Abstract: Funds of funds are an increasingly popular avenue for hedge fund investment. Despite the increasing interest in hedge funds as an alternative asset class, the high degree of fund specific risk and the lack of transparency may give fiduciaries pause. In addition, many of the most attractive hedge funds are closed to new investment. Funds of funds resolve these issues by providing investors with diversification across manager styles and professional oversight of fund operations that can provide the necessary degree of due diligence. In addition, many such funds hold shares in hedge funds otherwise closed to new investment allowing smaller investors access to the most sought-after managers. However, the diversification, oversight and access comes at the cost of a multiplication of the fees paid by the investor. One would expect that the information advantage of funds of funds would more than compensate investors for these fees. Unfortunately, individual hedge funds dominate fund of funds on an after-fee return or Sharpe ratio basis. In this paper we argue that the disappointing after-fee performance of some fund of funds might be explained by the nature of this fee arrangement, and that fund of funds providers may actually benefit from considering other possible fee arrangements. These alternative arrangements will improve reported performance and may make funds of funds more attractive to a growing institutional clientele.

1. Introduction

Despite the growing interest in hedge funds, it is difficult for many individual and institutional investors to participate in this area of the market. Minimum wealth levels and sophisticated investor requirements constrain many small investors. Legal limits on the number of U.S. investors allowed in hedge funds effectively place a lower bound on the size of investment most hedge fund managers will accept. In fact, many otherwise attractive hedge funds are closed to new investment. For those open to new investment, the minimum unit size is usually quite substantial. Thus, even for smaller institutions and endowments it can be expensive and in many cases impractical to invest in hedge funds with a prudent degree of diversification. Unlike registered investment companies, hedge funds are not required – indeed by most legal interpretations not allowed to publically disclose performance and holdings information that might be construed as solicitation materials. This has the unfortunate effect of making it more difficult for potential hedge fund investors to evaluate managers on a comparative basis. In

addition, little public information exists about fund operations and their holdings and investment strategies are typically undisclosed for strategic reasons.

Funds of funds (sometimes in this context referred to as “funds-of-hedge funds”) [FOF] are financial intermediaries established to address several of these issues. They are hedge funds themselves which hold shares in other investment companies and charge a fee for doing so. According to Tremont TASS (Europe) Limited (hereafter TASS), a London-based information and research company dedicated to the alternative investment industry, FOFs comprise a significant proportion of the hedge fund business. As of December 2003, the TASS hedge fund database contains 4,301 hedge funds, including 2,589 survived funds and 1,712 dissolved funds. The total assets under management are about \$330 billion. According to TASS, 23 percent, or 605 of the surviving funds are classified as FOFs.. The fraction of funds classified as FOFs has risen considerably over time. At the beginning of 2000, only 15 percent of the funds were classified by TASS as FOFs.

The typical FOF invests in a range of hedge funds. They allow investors to participate in hedge fund investments that are otherwise closed, and allow for diversification across hedge funds. They also provide professional management services and access to information that would be difficult or expensive to obtain on a fund by fund basis by the investor. For this reason, some authors argue that the appropriate index of hedge fund return is indeed the return on well managed FOFs.¹

¹Fung and Hsieh(2000).

However, the major disadvantage of this arrangement is the cost to the investor. In addition to the fees charged by the FOF, they effectively pass on to the investor all fees charged by the constituent funds, since, in most cases, they report their raw returns after all of the underlying manager fees are paid. A common concern among practitioners is that this double fee arrangement might induce FOF managers to invest in unduly risky hedge funds to ensure that the returns gross of fees are sufficiently large to absorb the FOF fees charged. While it is true that the FOF structure allows for diversification and hence reduction of risk at the fund level, there is an often overlooked cost to this diversification. The more diversified the fund is, the greater the likelihood that the investor will incur an incentive fee on one or more of the constituent managers, regardless of overall FOF performance. In fact there is a significant probability that the incentive fee will be so large that it absorbs all of the annual fund return.

The fact that FOFs incur incentive fees is not of itself a reason to avoid FOF investments. After all, an informed investor who invests in the underlying hedge funds would incur the same fees. However, such an investor would be able to hedge the incentive fee component at least to the extent that they could understand the underlying hedge fund positions. The problem arises as a result of the fact that investors choose to invest in FOFs precisely because they lack this necessary information. They are willing to pay management fees to FOFs to acquire information that is expensive or otherwise unavailable to them on an individual basis. On the other hand, FOFs are not obliged under current regulations to provide investors with current information on positions they take in constituent funds, let alone the positions taken by the underlying hedge funds. For this reason, FOF investors cannot hedge the incentive fees that are passed on by the FOF. The expected value of this unhedged fee then becomes a deadweight cost that impairs the performance of FOF investments. We document that this fee can be quite substantial, and is one

reason for the relatively poor performance experience of most FOFs.

The extent to which agents can hedge incentive fee contracts is of course a central issue in the emerging literature on management incentives in the investment management industry. Most researchers assume (for example, Carpenter 2000) that managers cannot hedge their incentive contracts. Ability to hedge the contract converts the incentive feature into just another form of manager compensation unrelated to performance. In many cases this constraint is descriptively accurate. Money managers are frequently constrained from trading on their own account where such trading can represent a clear conflict of interest. While it may be difficult, if not impossible to hedge incentive fee payments owing to hedge fund managers, at least FOF managers are not faced with this institutional constraint, and may in fact be better situated to hedge the fee component than is the average hedge fund investor.

What emerges from this theoretical literature is the implication that if incentive fees are effective, they will be more effective at the hedge fund or individual manager level than at the FOF level. Our empirical results provide support for this conjecture. Consistent with the results presented in Elton Gruber and Blake (2003) for mutual funds, we find evidence that incentive fees are associated with higher risk-adjusted performance for hedge funds. Some funds charge no incentive fees, while other funds charge fees that are 20 percent or more of the return above benchmark. Hedge fund Sharpe ratios bear a significant and positive relationship with the rate at which incentive fees are charged. The same result does not follow for FOFs. Here the rate at which incentive fees are charged is unrelated to performance.

The reason FOF providers do not hedge underlying fund fees is that it is difficult and

expensive to do so. Even with their informational advantage most FOF providers would find it impossible to completely hedge incentive fees due to the range and complexity of the underlying fund investments. However, it is possible under certain circumstances to hedge these fees at least in part, either as is often done, by charging an incentive fee on the basis of aggregate FOF performance, or by constructing partial hedges using correlated derivative positions² By doing so they would eliminate at least in part a deadweight cost which we show can be quite substantial. Where it is possible to do so, FOF managers can gain a clear advantage by eliminating the deadweight cost associated with the fee on fee structure and thereby report higher returns.

A central objective for many FOF providers is to attract institutional clients who have more of a long term focus than do retail investors. Fee on fee arrangements are common in brokerage arrangements serving high net worth individuals. However, they are not common in institutional fund management contexts because of a concern about the possibility of conflict that arises through such secondary fee arrangements. By shedding this so-called “wrap account” fee structure, the FOF provider may open the market to a new and significant institutional clientele.

In the remainder of this paper we describe the data used in the study and then in Section 3 document some of the differences between FOFs and the hedge funds in which they invest, not only in their observed characteristics, but also in the extent to which fee structures are related to

²Fung and Hsieh (1997b, 2001) and Agarwall and Naik (2004) show that many hedge fund positions are highly correlated with long and short positions in benchmark derivative securities.

performance. In Section 4 we provide some examples that give an illustrative order of magnitude on incentive fees and the deadweight cost they impose. In Section 5 we document an emerging fee structure arrangement that may yield superior after-fee returns for investors, and yet be approximately revenue neutral for FOF managers. Section 6 concludes.

2. Data

We use the dataset provided by TASS which contains data on after-fee returns for the period February 1989 through December 2003. Anecdotal evidence suggests that fees on average have fallen since that date due to the entry of CALPERs into the hedge fund market, but this is not indicated in the TASS database, which suggests that the fees voluntarily reported to TASS subsequent to that date may not be accurate. The dataset also includes the TASS “graveyard” – funds that existed in the period 1994 to the present but which have since dropped from the active fund sample. The last three months of data were excluded because of concerns about late reporting by a subset of hedge funds covered in the report. TASS also provides data on the considerable variety of fee structures used by hedge funds, including management and incentive fees. Among other things, it documents performance benchmarks used in calculating fees, redemption charges, and other expenses payable by the investor. An accompanying file of notes records the many exceptions to standard fee structures. For example, in a number of cases, the incentive fee charged per dollar return in excess of the performance benchmark increases as a function of the positive performance realized by the fund in excess of benchmark. In most cases, this performance benchmark is zero, but in many cases the fund has to earn a fixed return typically 10 percent, and sometimes even as high as 30 or even 50 percent before incentive fees are charged. In other examples, the fund has to earn a return in excess of the Treasury Bill rate,

LIBOR or some other performance index benchmark. Highwatermark provisions typically require fund managers to make up losses relative to their benchmark from previous years before earning an incentive fee in the current period. This provision makes the valuation of the hedge fund management contract an interesting challenge (c.f. Goetzmann, Ingersoll and Ross, 2003).

To examine the relationship between fee structures and after-fee return, we use the total after-fee return provided by TASS for all hedge funds it surveys. However, to study the magnitude of incentive fees and to examine their impact on return we need some measure of before-fee returns. While the TASS database, in common with other hedge fund data providers, gives only returns after fees have been paid, it is possible using the fee schedules provided by TASS to calculate an approximation of the before-fee return.³ The resulting before-fee numbers are an approximation for several reasons. In the first place, there is some variation in when fees are computed and charged. In the overwhelming majority of cases, the fees are calculated on an annual basis, although there are a few instances where the fees are computed and payable on a quarterly basis, and one instance where fees are charged on the basis of a five-year return period. We assume for simplicity that all fees are computed and payable on an annual cycle. For this reason, in the results that use before-fee returns, we are forced to exclude funds for which we

³There is no uniformity in fee schedules across funds. A wide variety of benchmarks and highwatermark provisions are commonly in use, and in some cases, incentive fees are in fact a nonlinear function of return. In a small minority of cases these fees are dependent on the size of the investment with a discount offered for large fund holders. The fee schedules used to construct before-fee returns were based on the incentive fees and management fees reported in the December 2003 version of the TASS database with a zero benchmark. Results were checked by constructing the exact fee schedules determined from a close reading of the Notes section of the TASS database for a large subsample of the funds in our study. These fee schedules reflected the exact benchmark and high watermark provisions of each and every hedge fund contract. While the benchmark variation and nonlinearity of fee schedules is accounted for, it is not possible to adjust for variations by size of investment. The results reported in the paper were not sensitive to the use of precise fee schedules.

have less than one full calendar year of data. In addition, a minority of funds charge management fees that vary with the size of account. We also ignore this qualification in our before-fee results. Since we assume that highwatermark provisions are met as of the first year of survivorship free data (1994), we impart an upward bias in 1995 calculated incentives.⁴ Finally, there were 12 cases where the algorithm used to compute before-fee returns failed, and for this reason those funds were excluded from the before-fee analysis.⁵

3. Characteristics and performance of fund of funds⁶

Table 1 provides the basic statistics for FOFs and hedge funds. As expected, FOFs provide significant diversification potential. The notion that FOFs are unduly risky is not supported in the data. Not only do FOFs reduce by more than a third the standard deviation of monthly hedge fund returns, but they also significantly reduce the value at risk of hedge fund investment.⁷ This

⁴Brown, Goetzmann and Park (2001) show that not meeting the highwatermark provision two years in a row is a good predictor of fund failure and hence departure from our database in later years of our sample.

⁵The algorithm used to compute before-fee returns is as follows. For each year, the annual incentive fee was computed on the basis of an estimate of prior year before-fee returns. The estimate of before-fee returns is updated by adding back to the after-fee returns for each month, one twelfth of the annual fee expressed as a fraction of the prior month value accumulated at the estimated before-fee return. Convergence is achieved when successive estimates of the before-fee return differ in absolute value by less than 10^{-11} within 35 iterations. This algorithm failed in only twelve cases. These cases corresponded to short-lived funds with extraordinary volatility of returns.

⁶Liang (2003) provides a detailed descriptive analysis of the difference between hedge funds and FOFs.

⁷As indicated in Table 1, the lower 5 percent fractile of the empirical distribution of monthly fund returns is three percentage points higher for FOFs. This difference is significant at the 1 percent level. The range of FOF returns is also more limited, with the best fund earning an average of 3.12 percent on a monthly basis (over 10 months), while the worst performing fund in

value at risk result is particularly significant, as it is based on an examination of returns after all fees are paid. A fiduciary who is primarily concerned about the downside risk associated with hedge fund investment should seriously consider a FOF vehicle.

However, as noted before, diversification is not the only reason why investors invest in FOFs. These instruments provide the investor with professional management and due diligence services, as well as access to otherwise closed funds. One would expect that investors would be prepared to pay for these services, but that the additional return would compensate them for any fees charged. Unfortunately that is not the case. The average monthly after-fee return for FOFs is 0.61%, only a little less than two thirds of the .97% return for hedge funds over the same period of time, a difference that is both economically and statistically significant. The result was the same when broken down by styles of management, with the differences in average after-fee returns greatest for Emerging Markets, Global Macro and Long-Short Equity Hedge styles. In each of these cases, the differences are all statistically significant with t-values in excess of 3.0⁸.

This discrepancy has been noted in the finance literature. Fung and Hsieh (2000), for example,

the sample earned -.06 percent (over 84 months), a range that no doubt can be attributed in part to seasoning factors.

⁸There are a disproportionately large number of very small hedge funds and funds of funds in the TASS database. Larger funds (in excess of \$100 million in assets) experienced slightly higher average returns. The risk was also lower, with lower standard deviations and mean lower 5% fractile of -3.91 percent for hedge funds and -1.91 percent for FOFs. However, excluding the smaller funds does not affect in any way the comparison between hedge funds and FOFs given in Table 1. Both returns and risk measures are lower for FOFs than for hedge funds over the same period of time.

find that at least part of the reported under-performance of FOFs may be attributed to survivorship which effectively biases upwards the reported performance of individual hedge funds. According to Liang (2003), the annual survivorship bias for hedge funds is 2.32% per year while the bias is 1.18% for FOFs. The 1.14% difference in survivorship bias is not big enough for explaining the magnitude of performance difference between hedge funds and FOFs.. FOFs which actually hold the shares of hedge funds when they become available, and experience the monetary losses when they are incurred, perhaps better represent the actual investment performance of the hedge fund investor. Fung and Hsieh persuasively argue that FOF's are perhaps a better index of aggregate hedge fund performance. We are of course sympathetic to the survivorship story – particularly since the use of annual returns still includes some conditioning on survival. For this reason, it is essential to include returns on all defunct or non-reporting funds contained in the TASS graveyard file. The survival issues are important, but it is also useful to focus on the role of FOF fees as an additional explanation for the poor relative performance of FOFs⁹.

Table 1 documents some additional differences between hedge funds and FOFs. On average, FOFs are similar in size to the hedge funds in which they invest. However, an important difference is that fewer fund managers have a stake in their own funds. While 31 percent of FOF managers have a personal investment in their own funds, the corresponding percentage is 42

⁹Survival issues would suggest that hedge funds that survive have persistent returns (Brown Goetzmann Ibbotson and Ross, 1992). Brown Goetzmann and Ibbotson (1999) show that while hedge fund returns are not generally persistent, there is some negative persistence in FOF returns. This persistence is better explained by a negative drag on after fee performance due to fees than by a survival argument.

percent for hedge fund managers. The difference is significant at the 1% level. This result suggests that perhaps the underlying hedge funds are more incentive aligned than FOFs. Probably the most interesting result in Table 1 is the difference in management and incentive fees between the two fund groups. The median management fee for FOFs is 1.5%, comparing to 1% for hedge funds, reflecting the nature of the two-tier fee structure of FOFs. Both FOFs and hedge funds typically charge an incentive fee expressed as a percentage of fund returns over a specified benchmark. In addition both FOFs and hedge funds are typically required to make up for past losses before incentive fees may be charged (the “highwatermark provision”). However, the median incentive fee charged by FOFs is only 10%, comparing to 20% for hedge funds. The differences in fees reflect the different incentives of FOF managers and hedge fund managers¹⁰.

Since FOFs provide significant diversification potential, an investor might expect that the reward to volatility ratio is higher for FOFs than it is for the average hedge fund. In Table 2 we report the average Sharpe ratio on an annual basis for FOFs and hedge funds during the nine-year period from 1994 to 2003, the period for which we have survivorship-free data. FOFs offer consistently lower Sharpe ratios, as well as lower average returns in many of the years documented. The same result follows when we break the funds down by the amount under management. There is little difference in Sharpe ratios across FOF size categories, while the Sharpe ratio for hedge funds increases with the size of the fund, from .3657 for funds in the

¹⁰Twenty nine percent of the larger FOFs in our sample (in excess of \$100 Million) do not charge any incentive fee, although the median fee is the same (15%) and one fund charges as much as 25% of the return above benchmark. The story is similar with management fees, although only one fund charges no management fees, eighty six percent charge in the region of 1% to 2% management fee.

range of \$100 - \$150 Million, to .4722 for funds with in excess of \$500 Million under management. The implication is that direct investment in individual hedge funds, on average yields a higher reward to variability ratio – and that a levered position in FOFs that matched the expected return of the hedge fund sample is in fact *riskier* at least in terms of standard deviation. The data suggest either that FOF managers have not done a particularly good job at selecting superior hedge funds, or that the fees they charge more than capture the benefits they deliver.¹¹

A cross-sectional analysis of the FOF universe is perhaps more instructive, since it allows us to compare managers that are subject to similar survival conditioning and similar evaluation by the investment community. In Table 3 we examine the extent to which FOF fees are related to performance. The FOF fee structure can be broken down into the incentive fee that gives the rate at which incentive fees are charged, and the management fees which represent the fixed percentage of assets under management used to pay for management expenses and other fees. As noted before, there is a rich variety of ways in which the incentive fee benchmark is specified, but this variation is not reflected in Table 3.

¹¹Differences in Sharpe ratios do not necessarily indicate differences in skill where returns are left-skewed due to inclusion of derivative securities or option-like trading strategies (Goetzmann, Ingersoll, Spiegel and Welch (2002)). However, in this case FOF returns are actually more left skewed (average skewness -.162) than are individual fund returns which are not on average skewed (average skewness 0.051) and the difference is significant at the 1 percent level. For this reason it is difficult to attribute the higher Sharpe ratio of individual funds to increased negative skewness in the distribution of returns. This argument does not affect cross sectional results reported later in the paper. Lo (2002) advises care in the interpretation of hedge fund Sharpe ratios where positive autocorrelation in monthly returns can cause an upward bias in the estimated ratios. While the average first and second autocorrelation coefficients are significant (albeit smaller in magnitude than for the sample that Lo (2002) reports), they are significantly higher for the FOF sample. Hence we cannot attribute a lower FOF average Sharpe ratio to an autocorrelation artefact.

A linear regression of after-fee performance on the rate at which incentive fees are charged finds no connection between the two. Cross sectionally, it appears on the other hand that FOF managers that charge higher management fees achieve a lower risk adjusted return. Interestingly, no such relationship exists for hedge funds taken as a whole. It appears that the management fee for the typical FOF company is a deadweight load that has the effect of simply reducing after-fee return. On the other hand, the rate at which incentive fees are charged does have a significant positive relationship with risk adjusted returns for individual hedge funds. The conclusion is clear. While the fee structure appears to provide an appropriate incentive for hedge fund managers, it does not appear to motivate FOF managers to achieve superior returns. It is important to note that the table shows the relationship between the rate of fees charged and current performance in the cross section of funds. It does not test the proposition that high current fees are associated with higher future performance. This is a very interesting issue for future research.

4. An example

The FOF charges incentive fees based on the after-fee return to the individual hedge fund. This implies that the ultimate investor may end up paying incentive fees regardless of how well or poorly the FOF actually performs. To see how this might happen, consider a very simple numerical example given in Table 4. In this example we assume for simplicity that all funds charge a standard 20 percent incentive fee over a zero benchmark with no fixed management fee. With just three funds, the first and second funds may perform well, earning 20 and 40 percent respectively. However, if the third fund performs sufficiently poorly, the overall fund may end up losing money. In this example, the before-fee return is -5 percent. However, there are

incentive fees owing to the first two funds, amounting in total to 4 percent of the assets at the start of the year. This 4 percent represents an additional fee that is subtracted from returns in calculating the after-fee returns. In this example, the after-fee return correspond to a loss of nine percent. While the investor escapes the FOF incentive fee because of a negative portfolio return, he or she must pay the incentive fees to the underlying managers. While an accounting of the incentive fees of the underlying managers is generally not explicitly provided to the FOF investor, the fees are never-the-less genuine monetary expenses that the intermediary institution pays and passes through to the client.

The example given in Table 4 is obviously an extreme example meant to illustrate the point. Under realistic circumstances, can it ever happen that an investor is liable for incentive fees when the fund as a whole loses money? Unfortunately, the answer is yes. To examine in some greater detail the relationship between fees and returns, we consider an example where FOF managers provide diversification services. However, consistent with the results in Table 1, the FOF managers do not add to returns through active selection and weighting of component hedge funds. We calculate the historical returns on FOFs from 1995 to the end of 2003 constructed by choosing the constituent funds at random from the set of hedge funds in business at the beginning of the period. As funds leave the sample, they are replaced by other funds in business at the time. We perform this exercise first for FOFs comprising only one fund, and then we consider what happens when we add more funds to the FOF. Stating returns on the underlying managers on a before-fee basis allows us to decompose the return to the FOF investor into the portion attributable to the underlying portfolio, the portion attributable to underlying manager fees, and the portion attributable to the FOF fees.

In Figure 1 we take the first case, where the hypothetical funds consist of only one fund. The data corresponds to all 830 hedge funds which according to TASS were operating at the start of 1995 and for which we were able to compute before-fee returns, excluding all FOFs. We then compute the realized annual returns to 830 hypothetical FOFs each investing in one and only one of these funds.¹² In this example, the incentive fees charged by the funds and the highwatermark benchmark before which fees are paid correspond to the actual fees and benchmarks listed by TASS for each of the funds. The hypothetical FOFs charge a 10 percent incentive fee over and above a zero benchmark. The solid line gives the relationship between returns and incentive fees suggested by an incentive fee schedule where the FOFs charge an incentive fee on top of the 20 percent of return fee charged by the individual fund.¹³ Funds may actually charge less than this, either because they have more modest incentive fee schedules, or because of the requirement that they earn back past losses before they are awarded this incentive fee (the highwatermark provision). Most funds employ a zero benchmark before they are entitled to an incentive fee, while some have a fixed benchmark or a benchmark based on an index return (T Bill rate, LIBOR or other benchmark).

We see that there is a great variation in realized before-fee return across years and across funds.

It is important to note that extreme returns may be on a very small base. The largest return

¹²To deal with the fact that not all 830 funds survived the entire period we assume that the FOF manager was astute enough to withdraw funds the month prior to the fund leaving the database, and reinvest the proceeds in another hedge fund in operation at that time. This will of course typically overstate the realized returns, as funds fail without prior warning, and in many cases there are restrictions that prevent such rapid withdrawals.

¹³These incentive fees and the benchmark correspond to the median numbers recorded in the TASS database.

recorded in the database was 441 percent. This return, as high as it was, did not generate an incentive fee, as in this particular case the fund lost 95.6% of its value in the prior year. The quadrupling of value was insufficient to erase the prior year losses. As noted above, the losses could even be greater, as we exclude from our database funds immediately prior to failure. One of the major attractions of FOFs is that they provide the investor with the opportunity to diversify and hence alleviate this volatility.

In Figure 2 we consider the same period of data, for a set of 830 hypothetical funds equally invested as of the beginning of 1995 in five hedge funds chosen entirely randomly from the set of available funds¹⁴. Diversification decreases the incidence of extreme returns, both negative and positive. At the same time however, diversification appears to be costly. The more diversified the FOF, the greater is the chance that at least one of the funds generates an incentive fee to an underlying manager. Since the FOF provides after-fee returns to the investor, the investor may in effect be paying an incentive fee regardless of the performance of the overall fund. In fact, we find that the investor may actually end up paying incentive fees to the underlying managers that exceed the annual return on the fund. In the Figure we highlight the 18.22 percent of fund/year returns for which this is the case. Comparing Figures 1 and 2 we find that diversifying into as few as five funds can substantially increase the probability of paying fees on negative returns. When the fund earns less than 20 percent before fees, the additional

¹⁴It is important to note that this illustration does not represent the actual trading results of any actual FOF, but is meant to be illustrative of the nature of the fee/return relationship implied by reported fee arrangements. FOF providers would not normally choose funds at random, and furthermore a survey of FOF providers show that the actual number of hedge funds held by FOF is close to 13 (Liang, 2003).

fees can amount to between two to three percent of assets at the start of the year. It is important to note that these fees do not accrue to the FOF provider when the fund as a whole loses money. Rather, these are incentive fees paid to individual funds and are passed on to investors in the form of after-fee returns through the FOF vehicle. When we consider a case of ten funds chosen at random, the FOF investor almost always has to pay an incentive fee to an underlying manager. In fact out of 7,470 fund years, there was only ten cases, or 0.1339 percent of the funds in which no incentive fees were charged, despite fund returns falling as low as -29 percent per annum on a before-fee basis. Funds that lose money on a before-fee basis lose on average an additional 1.1 percent on an after-fee basis accounting for incentive fees paid, and this additional burden can rise to as much as 5.7 percent. When we go to 20 funds per FOF (Figure 3), the incentive fees paid resemble what would be charged under a fee structure that charged an additional 2.5 percent management fee plus an incentive fee on returns in excess of a 15 percent benchmark criterion.

It is very important to note that the fact that investors end up paying incentive fees when the FOF loses money is of course not a criticism of the FOF diversification strategy. Individual investors investing in the same funds would suffer the same fees, and diversification does not increase the fee burden. To take a very simple example, suppose a FOF were to be fully invested in a hedge fund with a 2:1 leveraged position in a S&P 500 contract. Again, for simplicity assume that all assets are lognormally distributed with zero drift and a zero riskfree rate. The investor would pay an incentive fee half of the time. The expected value of this fee is increasing

in volatility and would equal 4.2 percent if annual volatility is 40 percent.¹⁵ On the other hand, if the fund invested half of the funds in a hedge fund comprising a leveraged S&P 500 position, and half of the funds in a fund that maintained an equivalent short position, then the investor would pay half of the incentive fee all of the time. The expected value of both the incentive fee and of total returns is identical in both cases.

The difference of course is that the individual informed investor can potentially hedge the incentive fees charged by the hedge fund, whereas they may choose to invest in the FOF precisely when the necessary information for hedging purposes is unavailable or expensive to acquire. In the simplified fact situation given above, the Black-Scholes value of the incentive fee call option is 3.2 percent. The difference (in this example, one percent) is always positive and an increasing function of volatility, and amounts to a significant deadweight cost associated with not hedging the underlying hedge fund incentive fees. In a more realistic setting, the magnitude of this deadweight cost will depend in a complicated way on the capital market assumptions, the incentive fee, benchmark and highwatermark provisions. Taking the historical fund volatilities and incentive fee arrangements from the TASS database, it is possible to estimate the magnitude of the deadweight cost for each of the years 1995 through 2003 (Table 5).

5. Alternative fee structures

The results reported in Tables 2 and 3 suggest that far from encouraging FOF managers to seek out higher risk adjusted returns, the current incentive fee on fee arrangements represent a

¹⁵For an initial fund value $S = 1$, the expected fee is given as $.2 (E(S|S>1) - 1) \Pr(S>1)$. If the annual return on the fund is lognormal with zero drift and volatility $.2$, the conditional expectation $E(S|S>1)$ is 1.42 (Johnson and Kotz (1970) p.129), and the expected fee is 4.2% of initial fund value.

deadweight cost passed on to investors, payable whether or not the fund as a whole makes a positive return, consistent with the example given in Section 4. The challenge is to discover whether there are any alternative fee arrangements which might serve the purpose of reducing this deadweight cost and thereby improving reported performance.

As we note above, the fee on fee arrangement is a feature of retail wrap accounts common in the wealth management business. However, there is no general uniformity in fee arrangements, and this is an area that is highly negotiable in practice. It is understandable therefore that large institutions entering this market are putting pressure on fees charged. One area of negotiation may be in the fee structure itself. Large institutions are not responsible for the annual bonus payments made to star managers within managed accounts, but rather negotiate a fee for managing the total account. In the same way, they might begin to expect FOF providers to absorb incentive fees of individual hedge funds in return for a fixed fee/incentive fee package paid to the FOF provider. It ought to be possible to negotiate a fee package at the FOF level that would end up at least approximately revenue neutral to the FOF provider. Investors in the FOF would only pay incentive fees on positive performance. Finally, this policy would concentrate attention on adding value at the FOF level where the FOF manager can in fact earn a substantial incentive fee.

Indeed, it is the practice elsewhere in the funds management business for the fund management company to absorb fees and expenses in return for a fee charged at the fund level. Mutual funds for instance, frequently compensate money managers employed by them using annual bonuses and other forms of performance related compensation. These incentive fees are then considered

part of the management expenses that are passed on to investors in the form of a management fee computed on the basis of a flat percentage of the assets under management.¹⁶ Very rarely do mutual funds charge incentive based fees, and SEC guidelines require that any such fees be symmetric in nature.¹⁷ The very prevalence of this type of arrangement suggests the conjecture that it may in fact resolve a number of the agency issues that arise in the context of fund management.

The net cost to the fund of funds providers may not be that great. Take the simple case where a fund of funds provider charges a 20 percent incentive fee on returns in excess of the annual Treasury Bill rate, in return for which the fund absorbs any and all similar incentive fees charged by the constituent funds. If all of the constituent funds have a similar volatility, then the economic cost to the fund is easy to calculate and will depend only on the volatility of the underlying funds and the extent to which fund diversification reduces aggregate fund volatility.

To see this, note that essentially the fund is short a portfolio of $k \times p$ call contracts where k is the number of funds in the fund of funds, and p is the incentive fee for each (in this case, 20 percent), where the exercise price for each call is equal to the future value of the beginning of year fund value at the riskless rate of interest. It is long p calls on a portfolio consisting of k funds. It is possible to determine the appropriately hedged cost of providing this service to fund

¹⁶Carpenter(2000) describes the consequences of these manager incentive payments on their risk taking behaviors.

¹⁷Incentive fees are relatively new to the mutual fund industry, and are discussed in Elton, Gruber and Blake (2003)

clients¹⁸. If for simplicity we neglect the highwatermark provision typical in such incentive contracts¹⁹, rearranging the Black Scholes formula, one can easily show that not only is the net cost positive, but it depends only on the volatility of the original funds and the extent to which diversification reduces that volatility.²⁰ Furthermore, this value is small in absolute value. In Figure 4 we plot the net cost as a function of the volatility of the underlying funds and the extent to which diversification reduces the risk of the overall fund. For the data considered in Section 2, the median fund had a volatility of 17.1 percent. A five fund portfolio reduces the median volatility by 66.4 percent. As a result, the cost is calculated as 0.46 percent of the initial fund value. This is certainly much smaller than the two percent of fund value deadweight cost that the existing fee arrangement penalizes fund of funds investors.²¹ The figure also illustrates the tradeoff between increased cost and volatility reduction resulting from fund of funds diversification. A fund that invests in many small high risk hedge funds would anticipate the largest benefit from diversification in terms of risk reduction. However, when each of these small funds charges a substantial incentive fee, the net cost can be large (top left corner of the

¹⁸Presumably the fund of funds provider is in a better position to hedge the individual manager incentive fee contracts than is the ultimate investor, given that he or she has timely and accurate information on position sizes.

¹⁹Goetzmann, Ingersoll and Ross (2003) describe the adjustments that must be made to account for the highwatermark provision.

²⁰The formula is $2p(N[\frac{\sigma_0}{2}] - N[\frac{\sigma_1}{2}])$ for time to maturity τ one year, $S = 1$ and $K = S e^{r\tau}$, where σ_0 is the volatility of the k underlying funds, and σ_1 is the volatility of the portfolio of those funds. This formula does not depend on the risk free rate or number of funds.

²¹Using a portfolio of calls in place of the desired call on the portfolio is akin to certain inefficient dynamic trading strategies which also result in net positive deadweight costs to investors (Dybvig 1986)

figure).

The net cost to the investor of this alternative incentive fee arrangement may be quite small. In Table 6 we report the average Sharpe ratios for random portfolios of 5, 10 and 20 hedge fund portfolios, along with the reported Sharpe ratios for all funds of funds over the same period of time. It is important to note that by random selection of hedge fund portfolios we are making the unrealistic or worst case assumption that the FOF manager is not adding value by selection of hedge funds. By the same token, the portfolio is not being manipulated to artificially increase the Sharpe ratios reported. Nevertheless, it is interesting to note that these random portfolios experienced Sharpe ratios an order of magnitude similar to those of managed funds of funds over the same period of time. We report the differences in average Sharpe ratios as an appropriately scaled measure of the cost to the investor of switching from the standard fee on fee arrangement to an alternative where for an additional 0.46 percent fixed management fee, the fund of fund manager replaces the individual incentive fee with an incentive fee computed on the basis of total fund return over a zero highwatermark. In each case, the Sharpe ratio for the investor improves under the alternative fee arrangement, while at the same time the fund of fund manager is made revenue-neutral in expectation. In other words, the additional uncertainty he faces is compensated. Consistent with the analysis above, the benefit to the investor of this new fee arrangement increases in each case as the fund of funds becomes more diversified.

The puzzle then is why more FOF providers do not absorb incentive fees in exchange for a simple fee structure with a slightly higher management fee and an incentive fee component that covers the underlying hedge fund fees. Such an arrangement would lead to a major improvement

in reported performance at small cost to the FOF provider, while at the same time increasing the institutional market for these funds. For the fact is, few do.²² While much of the financial risk to the FOF can be eliminated by having the FOF charge an incentive fee on its own account, not all of it is. It is impractical to consider hedging this risk, although this might be possible in certain specialized instances where the risk might be absorbed by hedging derivative positions highly correlated with each hedge fund strategy. Small FOF providers simply cannot afford this magnitude of financial risk or otherwise obtain insurance against it.

It is worth bearing in mind that when properly explained to the clientele, funds that agree to absorb incentive fees would be able to charge higher fees on their own account. This might then be particularly attractive strategy for an emerging class of FOF managers who invest in a diversified set of funds within the same hedge fund family. In this instance, an disparity in fees would then just be a book entry offset. It would also be an attractive strategy for the very limited number of FOF providers who understand the positions taken by the underlying hedge funds sufficiently well that they can actually implement the necessary incentive fee hedges²³.

6 Conclusion

²²There are very few funds in the TASS survey which offer to absorb incentive fees of the funds under its management in the event that the fund as a whole lost money. There are reports that several large institutional investors are beginning to negotiate such arrangements with fund of funds providers both in the United States and in Europe.

²³There is an interesting parallel here to mutual fund companies investing in publically issued stock of corporations that compensate their managers in the form of bonus incentive arrangements. While incentive bonus payments rarely reach as high as 20 percent of net revenue, the argument in this Section suggests that mutual funds might be able to improve reported performance by using traded derivatives to hedge these incentive payments.

Despite the popularity of hedge funds as an alternative asset class, the high degree of fund specific risk and the lack of transparency give most reasonable fiduciaries pause. In addition, many of the most attractive hedge funds are closed to new investment. FOFs resolve these issues by providing investors with an appropriate degree of diversification and professional management that can provide the necessary degree of due diligence. In addition, many such funds hold shares in hedge funds otherwise closed to new investment. The chief disadvantage of FOFs is the high fees that are typically charged, with an incentive fee component that may under certain circumstances exceed the realized return on the fund. In addition to the fees charged by the FOF, the FOF typically passes on to the investor all fees charged by the constituent funds in the form of after-fee returns.

As we note, one of the principal advantages of the FOF arrangement is that it allows for diversification. But the more diversified the fund is, the greater the likelihood that the investor will incur an incentive fee regardless of overall fund performance. In fact there is a significant probability that the incentive fee will be so large that it absorbs all of the annual fund return. The fact that investors end up paying incentive fees when the FOF loses money is of course not a criticism of the FOF diversification strategy. Individual investors investing in the same funds would suffer the same fees, and diversification does not increase the fee burden as an informed investor would face the same fees if they diversified on their own account. The problem arises because investors lack information necessary to hedge incentive fees charged by the underlying hedge funds and passed on to the investor through the FOF in the form of after-fee returns. This inability to hedge underlying incentive fees represents a deadweight cost that may tend to

explain the relatively poor historical performance of FOFs relative to the hedge funds in which they invest. This cost arises because the ultimate investor, not the FOF manager, bears the cost of incentive fees incurred whether or not the overall fund makes money. In addition, the data does not indicate that the current incentive fee on fee arrangement leads to superior returns.

An alternative arrangement that would limit this deadweight cost and that is in fact common in other areas of the investment management business would have the FOF absorb the individual incentive fees generated by individual managers in exchange for a fixed fee/incentive fee charged at the FOF level. It is worth bearing in mind that when properly explained to the clientele, funds that agree to absorb incentive fees would be able to charge higher fees on their own account. As a result, a fixed fee/incentive fee arrangement could be devised which would be on average revenue neutral for the FOF provider. However, some financial risk remains, and we believe that this is the major reason why this alternative arrangement is not yet in common use.

Yet there are significant opportunities for FOF providers who can in fact absorb underlying hedge fund fees in return for a management fee/incentive fee charged at the level of the FOF. Such FOF providers would include funds that specialize in particular hedge fund subcategories, FOF managers who invest in hedge funds under the same corporate umbrella, and the very small minority of FOFs that understand the underlying positions sufficiently well to hedge them at least in part through derivative contracts in correlated securities.

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Table 1: Descriptive Statistics of Fund of Funds and Hedge Funds

Data is from Tremont TASS (Europe) Limited (TASS). There are 4,301 hedge funds, including 2,589 survived funds and 1,712 dissolved funds as of December 2003. There are 862 funds of funds and 3,439 hedge funds. 605 out of 862 funds of funds are live funds while 257 (or 29.8%) are dissolved. In contrast, 1,984 out of 3,439 hedge funds are live funds while 1,455 (or 42.3%) are dissolved. Assets and minimum investments are in millions of dollars.

Variable	Fund of Funds (FOF)			Hedge Funds (HF)			$t_{\text{FOF-HF}}$
	No.	Mean	Std. Dev.	No.	Mean	Std. Dev.	
Mean return ^a	797	0.6051	0.5555	3239	0.9734	1.4092	-11.65**
Std. dev. of return ^a	797	2.6019	2.3265	3239	4.2996	0.0218	-20.60**
Skewness ^a	797	-0.1623	1.2545	3239	0.0508	1.3027	-4.26**
Kurtosis ^a	797	3.4866	6.0510	3239	3.4136	6.7108	0.30
Lower 5% fractile ^a	797	-3.4748	4.1965	3239	-6.5418	6.5504	16.31**
1 st Autocorrelation ^a	797	0.1627	0.1911	3239	0.0978	0.2027	8.48**
2 nd Autocorrelation ^a	797	0.0180	0.1899	3239	0.0283	0.1797	-1.39
3 rd Autocorrelation ^a	797	0.0150	0.1420	3239	0.0117	0.1576	0.57
Assets	827	\$118.94	\$590.86	3378	\$127.58	\$549.18	-0.38
Personal investment ^b	862	0.31	0.46	3439	0.42	0.49	-6.19**
Management fee	862	1.51	0.75	3439	1.40	0.79	3.81**
Incentive fee	862	9.06	7.64	3439	18.46	5.91	-33.69**
Leverage ^b	862	0.55	0.50	3439	0.71	0.45	-8.57**
Age	797	66.39	47.06	3239	62.43	43.52	2.160
Notice period	862	33.58	28.6	3439	26.05	25.28	7.07**
Minimum investment	856	\$0.37	\$0.85	3335	\$0.78	\$5.06	-4.44**

^aEstimated for funds with a minimum of one year of continuous data.

^bDummy variables: 1 if yes and 0 if no.

**Significant at 1% level.

*Significant at 5% level.

Table 2. Performance and Risk: Fund of Funds versus Hedge Funds

The table reports the annual average return for the funds in the TASS database including defunct funds after 1993. The mean returns are reported in the second and the fourth column. The median returns are reported in the third and sixth column. The average Sharpe ratio for funds is based on calculations for the corresponding year of data, and is recorded in the fourth and seventh column. Column 8 reports a t-test of the difference in the mean return for hedge funds vs. funds of funds. Column 9 reports the results of a t-test for differences in the mean Sharpe ratio for hedge funds vs. funds of funds.

	Fund of Funds ^c			Hedge Funds ^c			<i>t</i> -value	<i>t</i> -value
Year	Mean Return	Median Return	Sharpe Ratio	Mean Return	Median Return	Sharpe Ratio	(return)	(Sharpe)
1994	-0.3233	-0.4530	-0.2961	0.1072	0.1642	-0.0141	-4.54 **	-6.51**
1995	0.8238	0.8613	0.2399	1.3895	1.2888	0.3835	-5.43 **	-3.75**
1996	1.0470	1.0800	0.4074	1.4447	1.3631	0.4480	-5.45 **	-1.13
1997	1.0036	1.1218	0.3590	1.4596	1.3407	0.3845	-5.54 **	-0.84
1998	0.0530	0.1694	-0.0478	0.4210	0.6672	0.0988	-3.38 **	-6.26**
1999	1.6584	1.4776	0.5696	2.0594	1.4181	0.4013	-3.76 **	5.80**
2000	0.5910	0.6875	0.2228	0.7589	0.8900	0.2050	-2.09 *	0.62
2001	0.3187	0.4236	0.1045	0.5002	0.5568	0.1678	-3.39 **	-2.59**
2002	0.1480	0.1682	0.0898	0.2100	0.2475	0.1428	-1.26	-1.63
2003	0.7914	0.7658	0.8206	1.3736	1.0117	0.5795	-11.43 **	6.99**

**Significant at 1% level.

*Significant at 5% level.

^cNumbers are calculated using funds with a minimum of six month return history within each year.

Table 3. Regression Results of Sharpe Ratio on Management and Incentive Fees

Data is from Tremont TASS (Europe) Limited (TASS). The dependent variable in the regression is Sharpe ratio of each fund; the independent variables are management fee, incentive fee, fund age, and logarithm of fund assets. Sharpe ratios are estimated using funds with a minimum twelve-month return history.

	Fund of Funds			Hedge Funds		
variable	estimate	std error	t-value	estimate	std error	t-value
Intercept	-0.8203	0.1041	-7.88 **	-1.0203	0.0589	-17.32 **
Management	-0.0736	0.0156	-4.73 **	-0.0145	0.0082	-1.76
Incentive	0.0026	0.0015	1.73	0.0045	0.0012	3.91 **
Fund age	-0.0009	0.0003	-3.02 **	-0.0006	0.0002	-3.31 **
Log(assets)	0.0701	0.0057	12.23 **	0.0713	0.0032	22.26 **
N	688			N 2948		
R ²	22.90%			R ² 15.58%		
Adj R ²	22.45%			Adj R ² 15.47%		

**Significant at 1% level.

Table 4: Example of Positive Incentive Fees Due on Negative Fund of Fund Returns

In this hypothetical example, a fund of funds is established with \$1M invested in each of three hedge funds that earn (before fees) 20%, 40% and -75%. Each of these funds charge an incentive fee of 20 percent above a zero benchmark. For simplicity, none of the funds charge a management fee.

Variable	Hedge Fund 1	Hedge Fund 2	Hedge Fund 3	Fund of Funds
Start of year (\$M)	\$1.00	\$1.00	\$1.00	\$3.00
Annual return (before fee)	20%	40%	-75%	-5%
End of year (\$M)	\$1.20	\$1.40	\$0.25	\$2.85
Incentive fee (\$M)	\$0.04	\$0.08	\$0.00	\$0.12
Incentive fee ratio				4%
Annual return (after fee)	16%	32%	-75%	-9%

Table 5: Deadweight Cost Estimates Associated with Not Hedging Fund Incentive Fees

For every hedge fund included in the March 2000 TASS database including all defunct funds but excluding designated funds of funds we infer before-fee returns on the basis of reported after-fee returns, fee structures and benchmarks reported to TASS for the fund. For each fund we first calculate the magnitude of incentive fees implied by the incentive fee provisions and stated benchmarks, allowing for the highwatermark provision that adjusts benchmarks to require the manager to recoup past losses before an incentive fee is charged. We then compute the Black-Scholes value of the incentive fee contract, based on the contract provisions, current Treasury Bill rate and measure of historical volatility based on the time series of before-fee returns for that fund. The cross-sectional average difference between the ex-post realized incentive fee and the ex-ante cost of hedging that fee we term the average deadweight cost associated with not hedging fund incentive fees. We provide t-values for this quantity.

Year	N	Average incentive fee as a percentage of start of year value	Average cost of hedging incentive fee	Average deadweight cost	t-value
1995	802	5.02%	1.61%	3.42%	5.70
1996	932	5.02%	1.38%	3.64%	7.61
1997	1126	4.91%	1.29%	3.62%	6.11
1998	1278	3.22%	1.21%	2.01%	4.76
1999	1405	7.37%	1.00%	6.37%	6.19
2000	1546	3.76%	0.96%	2.81%	5.54
2001	1618	2.58%	0.89%	1.69%	3.68
2002	1722	1.95%	0.70%	1.25%	4.30
2003	1565	3.04%	0.50%	2.54%	3.28

Table 6: Effect of alternative fee arrangements on average Sharpe ratios

Year	Actual results	Fee on fee arrangement			Alternative fee arrangement			Difference		
		5 funds	10 funds	20 funds	5 funds	10 funds	20 funds	5 funds	10 funds	20 funds
1995	0.2399	0.3793	0.4431	0.5406	0.4576	0.5413	0.6576	0.0782	0.0982	0.1170
1996	0.4074	0.3129	0.3722	0.4004	0.3964	0.4658	0.5025	0.0834	0.0936	0.1021
1997	0.3590	0.2698	0.2945	0.3044	0.3601	0.3887	0.4040	0.0903	0.0942	0.0996
1998	-0.0478	-0.0809	-0.0927	-0.1064	-0.0137	-0.0137	-0.0156	0.0672	0.0790	0.0908
1999	0.5696	0.3553	0.4164	0.4603	0.4930	0.5736	0.6252	0.1377	0.1572	0.1649
2000	0.2228	-0.0239	-0.0189	-0.0329	0.0812	0.0924	0.0855	0.1051	0.1113	0.1184
2001	0.1045	-0.0326	-0.0441	-0.0739	0.1371	0.1058	0.1006	0.1698	0.1499	0.1745
2002	0.0898	-0.0788	-0.1081	-0.1473	-0.6728	0.0517	0.0200	-0.5940	0.1598	0.1673
2003	0.8206	0.6844	0.7726	0.8784	0.8124	0.9777	1.1001	0.1280	0.2052	0.2217

This table reports the average Sharpe ratios computed for 830 hypothetical funds of funds created from an equal investment in 5, 10 and 20 hedge funds chosen at random as of December 1994. Failing funds were replaced in the portfolio by a random choice of funds active at that time. In the fee on fee case each case the hypothetical fund charges 1 percent management fee and a 10 percent incentive fee. The incentive is charged on the basis of after fee returns from the underlying hedge fund over and above a zero benchmark. In the alternative fee arrangement case, the underlying incentive fees charged by the hedge funds are paid for by the fund of funds manager in return for a 28 percent incentive fee (10 percent on top of 20 percent incentive above a zero benchmark) plus a 1.48 percent management fee. The Sharpe ratios are computed for each hypothetical fund on the basis of calculated returns after all management and incentive fees are paid. The reported differences are all significant at the 1 percent level. The actual results column gives the average Sharpe ratios for actual funds of funds, as reported in Table 2.

Figure 1: Incentive Fees and Performance

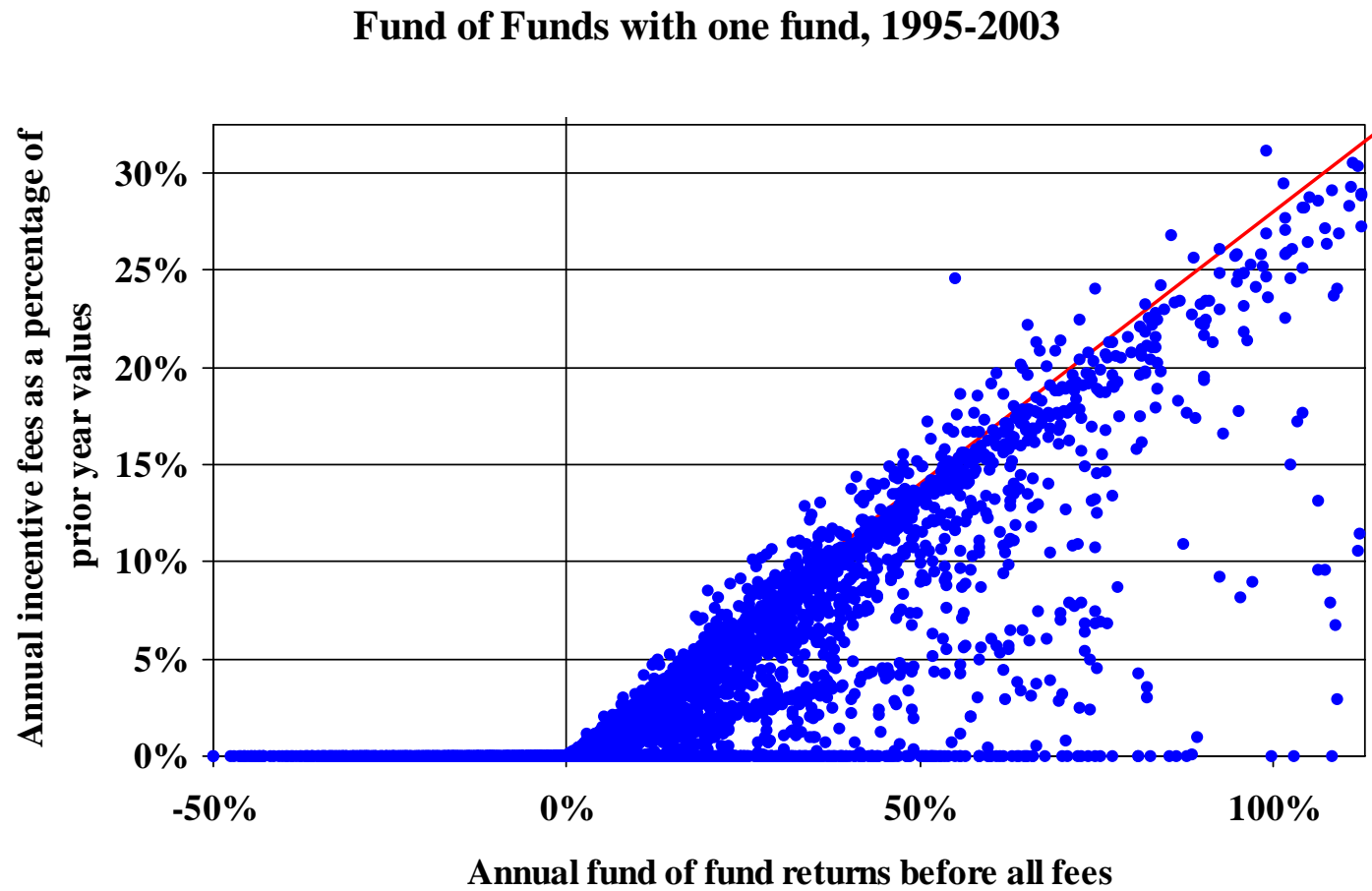


Figure 2: Incentive Fees and Performance

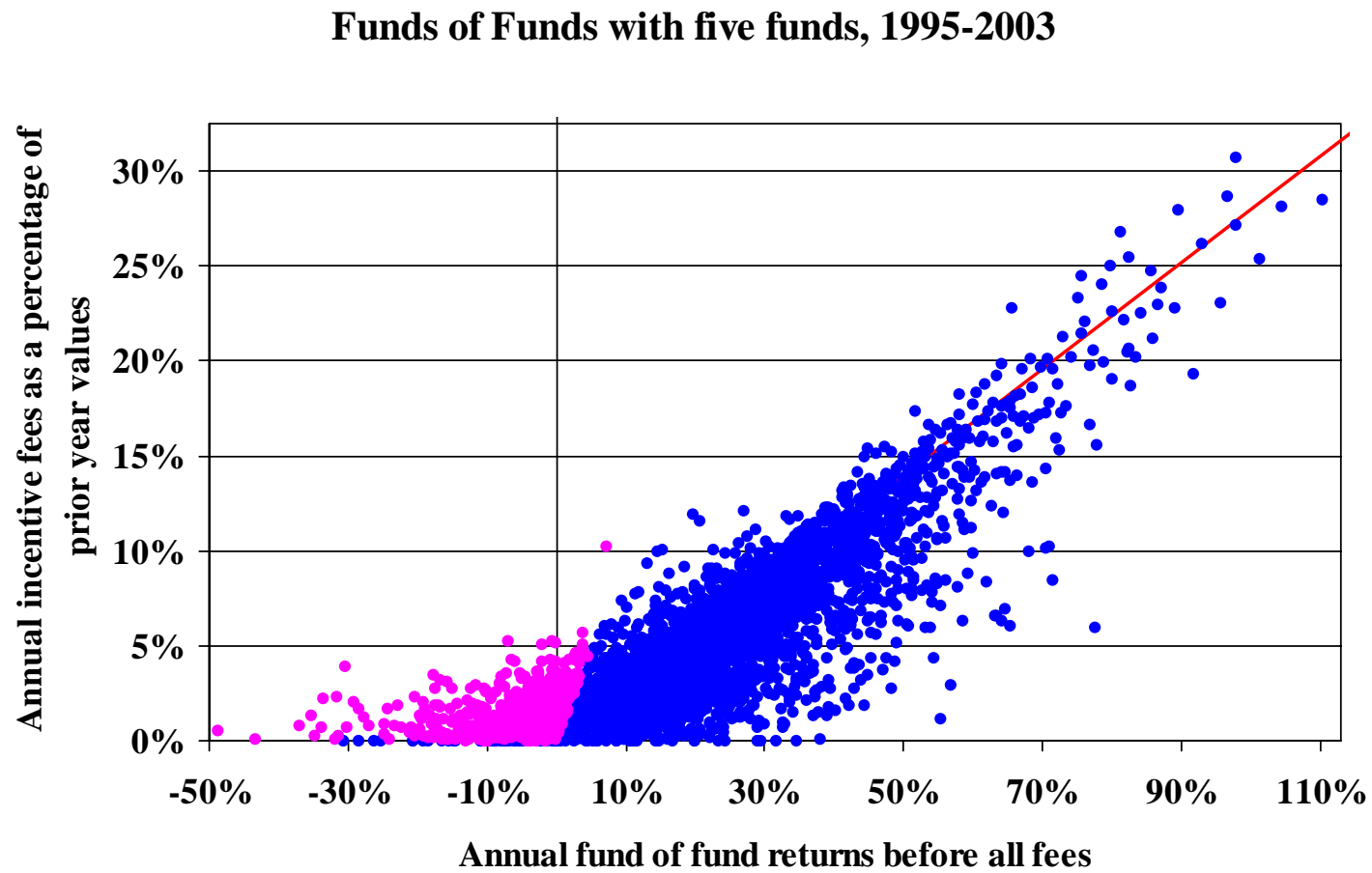


Figure 3: Incentive Fees and Performance

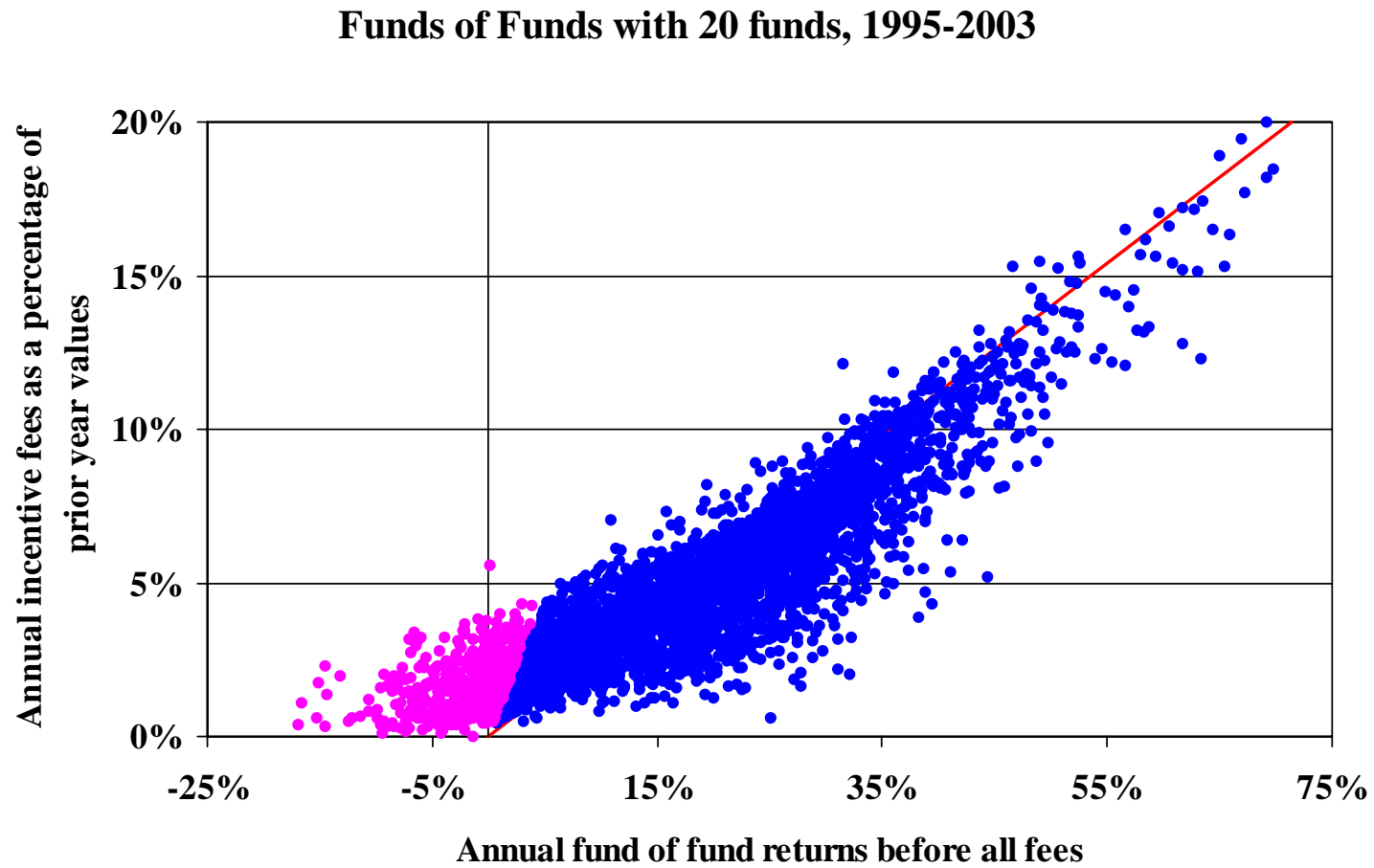


Figure 4

Cost of Absorbing Individual Fund Incentive Fees

